INTERIM REPORT

of the

SELECT COMMITTEE INQUIRING INTO HYDRO'S PROPOSED BULK POWER RATES

The Legislative Assembly of the Province of Ontario

FIRST SESSION: THIRTIETH PARLIAMENT

December 12, 1975

THE SELECT COMMITTEE INQUIRING INTO

HYDRO'S PROPOSED BULK POWER RATES

THE LEGISLATIVE ASSEMBLY OF ONTARIO

FIRST SESSION: THIRTIETH PARLIAMENT

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Donald C. MacDonald, M.P.P., Chairman	York South
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David Peterson, M.P.P.	London Centre
James A. Renwick, Q.C., M.P.P.	Riverdale
Douglas J. Wiseman, M.P.P.	Lanark

Counsel:	Alan M. Schwartz	Siegal, Fogler Barristers and Solicitors
Consultant:	James D. Fisher	The Canada Consulting Group
Clerk of the Committee:	Andrew Richardson	

TO: The Honourable Russell D. Rowe,
Speaker of the Legislative Assembly of the Province of Ontario:

Sir:

We, the undersigned members of the Committee appointed by the Legislative Assembly of the Province of Ontario on October 30, 1975, to review Ontario Hydro's proposals to increase bulk power rates for 1976, together with the report of the O.E.B. to the Minister of Energy thereon under section 37a of The Ontario Energy Board Act, dated October 10, 1975, and such other information as the Committee may consider relevant for its purpose, in light of the anti-inflation program of the Government of Canada; and the Ontario commitment to that program; and to prepare and submit a report before the end of December 1975, advising the Legislature whether, in the opinion of the Committee, such rate increase proposals are in keeping with or supportive of the anti-inflation program of the Government of Canada and the Ontario commitment to that program; and consistent with Ontario Hydro's obligation to provide power at cost; and if not, to report to the Legislature, with its recommendations, have the honour to submit the attached Interim Report.

Donald C. MacDonald, M.P.P.
York South,
Chairman

Donald C. MacDonald

Ray Haggerty, M.P.P.
Erie

Raymond L. Haggerty

James E. Bullbrook, M.P.P.
Sarnia

Lorne Maeck, M.P.P.
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MEMBERS OF THE LEGISLATIVE ASSEMBLY

Your Committee begs leave to present its Interim Report.

RECOMMENDATION

It is the recommendation of this Committee that its term be extended from the end of December 1975 to March 31, 1976, in order to allow the Committee to fulfil its terms of reference in a responsible manner, but that as an interim measure, Ontario Hydro be allowed to increase its bulk power rate by 22 percent on January 1, 1976, subject to the conditions contained in this report. This rate recommendation should remain in effect until the date of the Committee's final report.

ACKNOWLEDGEMENT

The Committee wishes to acknowledge with deep appreciation the contribution to its work of the staff - Alan Schwartz, Counsel, James Fisher, Consultant, and Andrew Richardson, Clerk. Without their untiring effort, the Committee could not have completed its difficult task within the severe time limit under which it worked.

CONCLUSION

The entire Committee approached its responsibilities with a single objective: to find some way to reduce responsibly the rate increase proposed by Ontario Hydro. In the light of the anti-inflation program announced by the federal government, and the provincial government's commitment to that program, the Committee specifically hoped that the 1976 rate increase could be kept to a level that could be related to the increase in incomes allowable under the guidelines. The Committee, therefore, carefully considered the impact an increase in the bulk power rate would have on the typical municipal rate and on the typical residential customer.[1]

The anti-inflation guidelines, in their current form, provided the Committee with no assistance in meeting its objective. The guidelines do not appear to be meant to apply literally to a corporation such as Ontario Hydro. Even if the anti-inflation program was meant to apply strictly, the guidelines, as they currently exist, do not appear to be the appropriate mechanism with which to control Ontario Hydro's prices. The Committee has noted its concern that a strict application of the guidelines appears to allow Ontario Hydro to implement a rate increase of over 25 percent.

In the time available to it, the Committee could not adduce evidence that permits it to conclude that a simple re-evaluation of Hydro's forecast costs will result in a reduction. However, in keeping with the broad spirit

1 - Ontario Hydro produces and transmits electric power to a variety of customers. It wholesales this power to 353 municipal utilities who are, in turn, responsible for the retail sale and distribution of it to commercial, industrial and residential customers. In addition, Hydro sells power in bulk directly to certain large industrial customers.

of the fight against inflation, the Committee concluded that a responsible interim reduction rate is justified. The recommended reduction must take into account the right balance between the fight against inflation and the short-term "financial integrity" of Ontario Hydro and the Province.

"Financial integrity", simply defined, relates to whether the financial communities are prepared to continue lending to Ontario Hydro and to the Province. The evidence before the Committee was that financial integrity generally does not erode slowly, but can disappear very suddenly. Also, the Committee was advised that the "financial integrity" of Hydro and the Province is interdependent. On the one hand, Ontario Hydro depends on the high rating accorded the provincial guarantee.[1] Hydro could not possibly raise all the capital it requires - even at higher rates of interest - without the provincial guarantee. On the other hand, the Province's credit rating is currently dependent on Hydro's perceived financial soundness. Although the gross debt of the Province - including provincial guarantees - is relatively high, most of that debt has been incurred as a result of Hydro borrowings and is considered "self-supporting". Self-supporting debt is considered to be debt invested in assets that earn sufficient money to pay the debt service charges that have been incurred. As long as Hydro maintains a reasonable financial position, the debt of Ontario Hydro will continue to be regarded as "self-sufficient"by the financial community and not as an obligation of the provincial taxpayer. If, however, Hydro is perceived by the financial community as being financially unsound, at least some portion of that debt would then be considered the taxpayer's obligation. This would likely result in the deterioration of the provincial credit rating.

1 - For historic reasons, the Province borrows in its own name in New York and relends to Hydro on the same terms. In all other financial markets, Hydro borrows in its own name with the benefit of an unconditional guarantee by the Province.

A strong credit rating is a vital concern to both Hydro and the Province at this time. Each must come to the financial markets for substantial amounts of money early next year. A lower credit rating raises the possibility that Ontario Hydro and the Province will be unable to raise the capital they require in 1976; a lower credit rating assures that the cost of whatever capital is raised will be higher.

The Ontario Hydro forecast of internally generated capital for 1976 is $630 million. The actual net interest payable by Hydro in 1976, according to the latest forecast, will amount to $555 million. An immediate reduction of internally generated capital of $75 million might be seen, therefore, as leaving the lender with inadequate protection should there be any drop in the demand for electricity or any problems with operating costs.

In order to reduce the impact of the bulk power rate increase on the typical residential customer to 12 percent, a cut of 6 percent from the proposed rate is required. A cut of this magnitude would reduce Hydro's internally generated capital by about $63 million - virtually wiping out the entire interest coverage and leaving the lender with no protection against any drop in demand for electricity or any problem in operating costs. It is the view of the Committee that immediate action of this nature may have a serious, adverse effect on the financial strength of both Ontario Hydro and the Province.

In determining the bulk power rate for 1976, the Committee, in the final analysis, sought to balance the short-term financial integrity of Ontario Hydro and the Province with the spirit of the fight against inflation. It concluded that an immediate cut in the bulk power rate of three percent was appropriate. This cut will reduce Ontario Hydro's internally generated capital by about $31.5 million. At this rate, Hydro

will fall far short of the level of interest protection currently deemed desirable by the financial community, but will be able to show some improvement over its very poor performance in 1975. In addition, the reduction will be seen by the financial community as a responsible one. It is an extraordinary measure being taken by a Committee that is prepared to continue its review of Hydro's operations so as to determine fully and responsibly Hydro's real needs.

The Committee's recommendation, at this time, is predicated upon Hydro covering its interest costs with a small margin of protection. The Committee is aware that a Treasury directive may result in Hydro's borrowings in 1976 being lowered by as much as $400 million. This should enable Hydro to project a lower level of interest charges for the coming year. The Committee expects Hydro to cut its rates by approximately one percentage point for each $10 million of projected savings. A reduction of borrowings of $400 million could, for example, justify a reduction in the rate increase of a further two percentage points.

The Committee has considered the impact a 22 percent increase in the bulk or wholesale power rate should have at the retail level. Taking the assumptions used by Ontario Hydro in Exhibit 13, filed with the Committee, the typical increase in the municipal rate attributable to the bulk power rate increase should be about 16.5 percent. The increase for the mythical, typical residential customer should, based on the assumptions upon which that customer is based, be 13.9 percent. The Committee noted that the reduction required to reduce the impact on the mythical, typical residential customer to 12 percent would result in a saving of approximately 30¢ per month for this customer over the Committee's proposed rate. The Committee concluded that the magnitude of the saving did not provide sufficient cause to risk putting Ontario Hydro or the Province in a position of being unable to raise needed capital in the period prior to its final report.

Finally, the Committee notes that the Board of Ontario Hydro has complete regulatory power over the rates charged by the municipal utilities at the retail level. The Committee expects that Hydro will use those powers to ensure that the municipal utilities operate within the spirit of the fight against inflation and will not, in 1976, attempt to improve their own relative financial conditions.

Dissent: Mr. J. Bullbrook (Sarnia) and Mr. D. Peterson (London Centre) regret that they are unable to sign the report of the Committee. While supporting totally the request of the Committee for an extension of its terms of reference to March 31, 1976, they feel that Ontario Hydro's bulk power rate should be lowered so that the increase in the average residential retail rate not exceed 12 percent.

I INTRODUCTION

Under the Chairmanship of Mr. D.C. MacDonald (York South), the Committee held 30 sessions to inquire into the proposed bulk power rate. The terms of reference of the Committee are included in this interim report as Appendix A.

On April 24th of this year, Ontario Hydro submitted a proposal to the Ministry of Energy for an increase of 29.7 percent for 1976. An important element in its new rate submission was a change in financial policy which allowed Hydro to recover deficits over five years and costs over three years, rather than in a single year. The effect of this change was to reduce the proposed rate from about 38 percent to the 29.7 percent request. Following the submission, new data and circumstances suggested that Hydro revise its proposal. A lower load forecast, significant reductions in secondary sales of interruptible power, revised forecasts of interest and cost escalations all contributed to a need to revise the original proposal of 29.7 percent slightly upward. Ontario Hydro, however, decided not to change the original proposal. Shortly thereafter, the Government's mini-budget, presented in July, included directives to Hydro to moderate its requirements. By cutting administrative costs, deferring the collection of deficits and cutting, in half, the system expansion charge for 1976, Hydro reduced its 1976 proposal to about 25 percent.[1] Following 55 days of hearings throughout the summer, the Ontario Energy Board recommended to the Minister that the rate increase be 26.7 percent for 1976. In so doing, the Energy Board confirmed that Hydro's cost estimates were reasonable and valid, and acknowledged the need for a system expansion charge.

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1 - In accepting the lower figure, the Hydro board made it clear that it did not depart from its conviction that the 29.7 percent contained in the original proposal was fully justified.

In considering the Energy Board's recommendation, the Hydro board was confronted with a new uncertainty: the federal anti-inflation guidelines. The Hydro board believed that it was not possible to assess fully the impact of the guidelines while meeting the requirement of informing their direct industrial customers of the 1976 rate 60 days prior to implementation. Under the circumstances, the Hydro board decided to stay with a 25 percent increase for 1976. Early in its current session, the Legislature formed this Select Committee to inquire into Hydro's proposed increase in bulk power rates, in accordance with specific terms of reference.

Over the past five weeks, the Committee has met almost daily. Individuals and organizations responded to an advertisement by writing to the Committee expressing their views on the proposal. Each submission received has been acknowledged and entered in the record, with copies made and circulated to each member of the Committee and its staff. In addition, the Committee has heard from a great number of witnesses in the very short, five-week period of its existence. These are listed in Appendix B and fall broadly into two categories. On the one hand, the Committee heard from and questioned representatives of the Government, organizations and individuals who provided outside perspectives on Hydro and its place in the Ontario economy. On the other, the Committee requested and questioned evidence presented by Ontario Hydro on the specific areas of Hydro's operations that impact most directly and significantly on Hydro's bulk power rates.

The balance of this report will present the Committee's overall findings and conclusions on the application of the federal anti-inflation guidelines to Ontario Hydro and on the adequacy of Hydro's revenue and cost projections.

II ANTI-INFLATION GUIDELINES

In accordance with its terms of reference, the Committee reviewed Ontario Hydro's proposals to increase bulk power rates for 1976 in order to determine whether, in the opinion of the Committee, the rate proposals are in keeping with, or supportive of, the anti-inflation programs of the Government of Canada and the Ontario commitment to that program. In so doing, the Committee had regard for both the guidelines for price and profits and the provisions of the program respecting increasing energy prices. In formulating its opinion, the Committee was acutely aware that neither the final form nor the content of the guidelines or regulations is known. All comments are, therefore, based on the White Paper itself, along with the accompanying Highlights Paper, and a subsequent further elaboration relating to "Regulated Industries and the Regulatory Process", to the extent that these can be interpreted in their initial wording.

The Committee has concluded that, at this time, it would be inappropriate to review Ontario Hydro rates within the strict meaning of the guidelines. Its conclusion is based on several factors. First, it is unclear whether the guidelines were meant to apply to a quasi-governmental Crown corporation whose rates are its main source of internally generated capital. Second, the structural policies in the guidelines relating to energy suggest that electric energy may be specifically exempt. Finally, the guidelines, as they currently exist, do not appear to be the appropriate mechanism with which to control Ontario Hydro's prices.

The provisions of the anti-inflation program respecting increasing energy prices state that:

> The situation in the energy field provides perhaps the clearest illustration of the difficult problems that must be overcome in finding and maintaining the right balance between a general policy of lowering the overall inflation rate and the need to permit an

orderly upward adjustment of the relative prices of certain important products and services.

The Committee recognizes that the anti-inflation program envisages a "balance between a general policy of lowering the overall inflation rate and the need to permit an orderly upward adjustment of the relative prices of certain important products and services." In the opinion of the Committee, this suggests that for certain important products and services it would be inappropriate to apply strictly the guidelines for price and profits. Furthermore, the program recognizes that: "Major efforts are also required to develop and exploit energy supplies efficiently and to limit further increases in the real cost of energy in the future." The Committee is aware of the role the Ontario Hydro commitment to nuclear operations will play in this regard. It is evident to the Committee that the program clearly recognizes "the need for substantial upward adjustment in particular areas of the price structure if adequate new supplies are to be forthcoming." It must be noted, however, that the guidelines do not specifically identify the electric energy field; it may very well be that the electric energy field was not even contemplated. As well, the guidelines, to date, provide no assistance whatsoever in the determination of the "right balance."

In order to determine whether the rate proposal was "supportive" of the guidelines, the Committee specifically considered the guidelines for price and profits. In so doing, the Committee first assumed that Ontario Hydro falls within the description of a firm which is able to allocate costs to individual products. These firms are expected to increase the price of their product by no more than increases in costs allocated to the product. The guidelines, as they apply to these firms, state that:

> To compute the increase in costs which may be passed on, it will be necessary to estimate the cost of a product on or near

October 14, 1975. A similar estimate of the cost of the product in question must be made at the date the selling price is to be increased. The difference between the two cost estimates is the maximum amount by which prices should be changed.

The selling price is to be increased on January 1, 1976.

The guidelines recognize that: "Costs may vary considerably from day to day and many firms may not customarily compute their costs on a daily basis. Therefore, the two required cost estimates should be made on a reasonable basis, and both should be consistent with the firms' usual accounting practices."

Throughout its calculations, the Committee was aware of the definition of costs allowable for purposes of justifying an increase in prices. Specifically, both the debt retirement charge and the system expansion charge were treated as net income or profit and not as cost.

Ontario Hydro can only allocate costs to its product on a reasonable basis and consistent with its usual accounting practices if it does so over the entire one-year period for which a single rate structure was in effect. It was considered inappropriate to use a cost estimate made on any one day on or near October 14, 1975, or, in fact, any cost estimate made from January 1, 1975, to October 14, 1975. In order to accurately estimate the cost of the product prior to October 14, 1975, therefore, the Committee considered that the closest appropriate time span was the period between January 1, 1974, and December 31, 1974.

In considering the appropriate information, it was assumed that Ontario Hydro is a firm which sets prices which "will be in effect for some period of time ahead." Therefore, it could make increases in prices on the basis of forecasts of cost increases. The guidelines state that:

These forecasts, however, should be based on known changes, or changes which can be expected to occur within the period for which the firms normally set prices in advance and which can be foreseen with a reasonable degree of assurance.

The Committee concluded that Ontario Hydro's forecasts of 1976 cost increases could be foreseen with a reasonable degree of assurance and could be expected to occur within the period of January 1, 1976, to December 31, 1976. The Committee did not, however, require Ontario Hydro to recast its 1976 forecast to provide for the effect the anti-inflation program would have on it. The Committee concluded that in the only areas in which the guidelines could reasonably be expected to affect the 1976 forecasts, the escalation factors used by Hydro were lower than the inflation factors implied by the guidelines.

In calculating the allowable increase in price which Ontario Hydro would be granted under this approach, the Committee was aware that the broad thrust of the guidelines would: "Restrict profits per unit of output, in dollar terms, to a firm's average per unit profits experienced prior to (October 14, 1975)." The calculation allows Ontario Hydro an increase of approximately 26 percent while remaining within this interpretation of the guidelines for price and profits.[1]

Since the Committee concluded that it was necessary to look to the period between January 1, 1974, and December 31, 1974, in order to estimate the cost of the Ontario Hydro product on or near October 14, 1975, it determined that, in relation to the applicability of the guidelines, Ontario Hydro might be considered a firm which is unable to allocate costs to individual products. This would result from a determination that the appropriate period is too remote from the contemplated date of October 14, 1975. In accordance with the guidelines, this type of firm ". . . should price

1 - See Appendix C

its products in such a way as to leave its percentage pre-tax net profit margin no higher than 95 percent of its average percentage pre-tax net profit margins in the last five completed fiscal years . . . The percentage net profit margin will be defined as profits divided by total operating revenue." The result of this calculation allows Ontario Hydro an increase of approximately 25.3 percent while remaining within this interpretation of the guidelines for price and profits.[1]

Finally, in this respect, the guidelines instructed regulatory agencies ". . . to use their powers over prices and the quality of service in order to ensure conformity with the program. The provincial governments are being asked to instruct their regulatory agencies to do likewise." An explanatory document released by the federal government stated that:

> It is proposed that the power to control price movements in the regulated industries continue to be vested in the regulatory agencies . . . With respect to the question of review under the anti-inflation program, it is proposed that the decisions of regulatory agencies operating under the delegation of guidelines should not be subject to direct Anti-Inflation Board review. They could, however, be made a direct subject of reference from Lieutenant-Governors-in-Council or the Governor-in-Council to the Administrator.

The Committee notes that Ontario Hydro's rates are reviewed rather than regulated by the Ontario Energy Board. However, the document states that: "The regulated industries comprise Crown corporations, utilities - publicly or privately owned - and corporations in the private sector." As the Committee is unaware of any publicly owned utility in Canada which is regulated in the narrow sense of the word, it considered that, for the broad purposes of the guidelines, a regulated industry may include any industry

1 - See Appendix D

whose prices are reviewed, in any manner, by a regulatory agency. Accordingly, the Committee examined Ontario Hydro's proposal in light of the explicit guidelines which regulatory agencies are to follow. These guidelines are as follows:

1. The general principle of increase in prices to amounts no more than required to cover net increases in costs should apply

2. Where regulatory agencies are required under their own legislation to provide for a "fair" or "reasonable" rate of return on capital and/or equity, this should be interpreted, for the purposes of the anti-inflation program, so as to ensure that regulated industries do not generate a larger proportion of their capital funds internally than has been their historic practices.

The Committee has concluded that the first principle clearly directs the regulatory agency to the broad thrust of the guidelines. While recognizing that Ontario Hydro does not fall within the strict application of the second principle, the Committee ascertained that Hydro will not, in fact, generate a larger proportion of its capital funds internally than has been its historic practice.[1]

In conclusion, it is the view of the Committee that the anti-inflation guidelines are not meant to apply literally to a corporation such as Ontario Hydro. Even if the anti-inflation program is meant to apply strictly, the guidelines, as they currently exist, do not appear to be the appropriate mechanism with which to control Ontario Hydro's prices. The Committee notes, with concern, that it appears possible for a firm such as Ontario Hydro to implement the largest rate increase in its history while apparently staying within the guidelines of the federal anti-inflation program.

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1 - See Appendix E

111 THE REVENUE AND COST STRUCTURE

Overall, the Committee has concluded that its investigations, to date, have revealed little in the revenue and cost forecasts for 1976 that could reasonably be changed as justification for a reduction in the 1976 rate. For its purposes, the Committee considered the forecast operating statement as being made up of four broad items as shown:

Revenue	$ 1,514	($ million)
Less:		
Energy Variable Costs	528	
Overhead	357	
Capital Charges	629	

A brief summary of the Committee's interim findings with respect to these items is as follows:

1. Revenues are made up of two components:

Primary power and energy	$ 1,402	($ million)
Secondary power and energy	112	
	$ 1,514	

The primary sales are those made to Ontario customers. In its preliminary investigation into the load forecasting procedure that produces an estimate of unit volume of primary sales, the Committee was presented with evidence of Hydro's remarkably good record of forecasting short-term demand. In addition, the consensus, at this time, seems to be that if there is an error in the forecast for 1976, the error will be on the high side - that is, sales are more likely to be lower than forecast in 1976, rather than higher.

Secondary sales are those sales made on an interruptible basis to utilities in the United States. The Committee spent some time inquiring into the feasibility of increasing secondary sales through the development of alternative selling proposals. The Committee found, however, that the

slower than expected recovery of the U.S. economy has left the U.S. utilities with more generating capacity in relation to the new forecasts of demand than had earlier been anticipated. Now, not only is there little chance for increased sales but, for 1976, even those sales currently forecast appear to be somewhat uncertain.

In accepting Hydro's forecast of export volumes in 1976, however, the Committee was not convinced that alternative ways of approaching U.S. sales may not produce higher or more assured revenues in the future - as long, that is, as Ontario Hydro has generating capacity in excess of its needs.

Thus, while the Committee believes that this is an area where Hydro could take a more flexible and imaginative approach, there is no reason for believing that Hydro's actual revenues in 1976 are likely to be higher than forecast. Since only a higher volume forecast could produce justification for a lower bulk power rate, the Committee has concluded that no relief can be found for the 1976 rates in this area.

2. Energy variable costs are made up of eight components:

	($ million)
Coal, ignition and c.t. oil	$ 238
Oil for generation	54
Natural gas	71
Uranium	37
Steam	3
Purchased power	76
Nuclear agreement - payback	33
Water rentals	16
	$ 528

The Committee could find no justification for reducing the forecast of energy costs. In its examination of Hydro's energy costs, the Committee found that the 1976 projections were either: committed by previous

contractual arrangements (purchased power, nuclear agreement and water rentals[1]); based on forecasts that appear to continue to be reasonable (natural gas, uranium); or, largely locked in by the process of accumulating inventories and accounting for consumption (coal, oil). The Committee found some evidence that small savings might be possible from coal and oil prices that may not rise quite as much as has been forecast, but concluded that any savings that might arise would be balanced out by a forecast of slight increases in coal consumption.

3. Overhead costs are referred to as operations, maintenance and administration and are forecast to amount to $357 million in 1976. Although the Committee is deeply concerned about the level of these costs, it could not, in the limited time available, probe deeply enough to find justification for changing Hydro's estimates. In reaching this conclusion, the Committee noted three important factors. First, the Ontario Energy Board in its hearings probed these costs and found no justification for reducing Hydro's estimate. Second, those areas of overhead cost that were drawn to the Committee's attention by some of the organizations that appeared before it did not, on preliminary investigation, appear to have significant possibilities for realistic cost reductions. Finally, the Committee found it difficult to justify an arbitrary cut, since in response to the peremptory directives contained in the Government's mini-budget, Ontario Hydro has already reduced its budget of overhead costs for 1976 by $30 million.

In accepting Hydro's 1976 forecast of operations, maintenance and administration costs, the Committee reiterates that it is not simply accepting that Hydro's overhead costs cannot be reduced. The Committee is firmly of the opinion that these costs should be subject to close and

1 - The Committee notes that a renegotiation of the nuclear payback and water rental agreements could result in a lowering of energy variable costs. While recognizing the complexities involved, the Committee encourages Hydro to continue the current negotiations, and the Government to balance carefully the overall effect on Ontario residents of the current agreement as compared to any contemplated changes.

careful scrutiny by this Committee.

4. Capital charges are made up of five components:

	($ million)
Interest	$ 319
Depreciation	169
Debt retirement charge	86
System expansion charge	72
(Deficit)	(17)
	$ 629

The Committee spent most of its time examining this area of Hydro's forecast needs. Rather than deal with each component separately, the Committee focussed its attention on the overall adequacy of the revenues set aside to finance Hydro's capital needs in light of its proposed system expansion plan. The Committee concluded that this is the area of Hydro's operation that demands the closest scrutiny by the Legislature. Close scrutiny is required because, over time, the most significant impact on Hydro's rates results from its plans to spend over $30 billion on the expansion of its electric generation and transmission system. In addition, the critical assumptions on which the expansion program is based are fundamentally socio-economic-political choices rather than technical decisions.

The Committee heard many different points of view on the capital allocations and appropriation. Many questioned the specific methods of determining depreciation, debt retirement and system expansion charges. Hydro made a case for maintaining or improving its financial soundness, usually referring specifically to the ratio of long-term debt to equity. Senior investment bankers from Toronto and New York referred to two measures of financial soundness - the debt/equity ratio and the times interest earned multiple.

In looking at the overall adequacy of the capital charges, the Committee noted that the debt/equity ratio is forecast to continue to

deteriorate through 1976 and the times interest earned multiple, while recovering from what will be a very bad year in 1975, will fall short of the standards deemed desirable by the financial community. The Committee decided that its standard of adequacy for capital charges would be the coverage of interest costs. (The actual cash outlay for interest expense, net of interest revenue, is about $555 million. This is far greater than the $319 million actually charged to operations.[1]) Hydro's forecast for 1976 is that, other than recovering from the current bad year, there will be no improvement in this ratio in 1976, so that it will remain below the standard of the financial community.

The Committee has not satisfied its many concerns about Hydro's planned system expansion program. The demand forecast, for example, does not assume any significant success in conserving electric energy use, although the Committee heard many interesting suggestions that could lead to less wasteful uses of electric energy. This is of particular concern in light of the evidence, albeit limited, that in other jurisdictions demand forecasts have been lowered. The reserve policies of Hydro also came under close questioning. The Committee, at this time, has been unable to weigh the relative risks and merits of lower reserve margins. Another area of inquiry was related to the mix of generating systems proposed in Hydro's plan. The Committee noted that generation mix decisions are related to such fundamental policy issues as the balance of short-term capital costs as against long-term operating costs, the worth to be assigned to security of fuel supply, the trade-off economy as against system reliability, and the prospect of tapping into the Baie James Hydro development.

Finally, serious questions were raised about the prospect that Hydro will not be able, or be allowed, to raise sufficient capital to fund

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1- Interest forecast in 1976:

Interest expense		$ 587 million
Less:	Interest income	32 million
	Interest capitalized	236 million
Interest charged to operations		$ 319 million

its proposed plan. This must be weighed against the other view that an adequate supply of electric energy for Ontario in the future is of such importance that no predetermined financial restraint should be allowed to dictate the direction of the system expansion program. As well, the Committee dealt briefly with the appropriateness of today's users paying through their rates for a system that is at least partly being built for another group of users. This may be of particular concern at a time when the evidence indicates that shortages of oil and gas may require many energy consumers, currently enjoying the advantages of these relatively lower priced products, to switch to electric energy.

Overall, in the time available, the Committee was unable to make any determination of the appropriateness of Hydro's system expansion plans. The Committee was, however, concerned about the need for, and direction of, such a massive expansion program. It found that it must probe more deeply the fundamental and unanswered policy questions concerning future demand, reserve policies, generation mix and financing.

In this regard, the Committee has recognized that the most significant determinant of bulk power rates is the capital expansion program of Ontario Hydro. This Committee's terms of reference require it to review Ontario Hydro's proposals to increase bulk power rates for 1976. In order for this Committee to carry out its task adequately, realistically and responsibly, it must of necessity review the system expansion program as well as examine the possibilities relating to alternative forms of financing. In reviewing the Ontario Hydro proposals for 1976, this Committee's terms of reference instruct it to: "Review such other information as the Committee may consider relevant for its purpose." It has been the overwhelming and uncontradicted evidence of the various witnesses who have appeared before the Committee that nothing impacts on rates to a greater degree than the level of the system expansion program and the manner in which that program is financed.

Currently, the most significant source of revenue generation available to Ontario Hydro is its rate structure. The rate level, therefore, particularly in its relationship to the overall level of capital expenditures, must be reviewed as the Committee's terms of reference direct, with regard to the maintenance of Hydro's financial integrity. In order to do so, the Committee must review the appropriateness of the relationship between these figures and review further the appropriateness of each of its component parts. Again, this of necessity requires a review of the system expansion program.

Finally, in regard to the terms of reference, the Committee has not had the opportunity of reviewing the rates while having regard to the "dependence (the Province of Ontario may have) upon adequate electric supplies for Ontario's future economic well-being." This complex matter cannot be left unexamined in any review of rates. Rates cannot be reviewed in a vacuum.

The Ontario Energy Board has made it clear that it recognizes the social and economic influence which Ontario Hydro exerts as a result of the scale of its activities and the importance of electric energy. However, it has also recognized that neither it - that is, the Ontario Energy Board - nor Ontario Hydro is in the best position to deal with these basic socio-economic matters. For its part, Ontario Hydro has consistently stated that it is not its place to establish policies in these areas but rather that it is bound to accept and act upon these matters when so directed by the Government.

The results of this review will help the Committee and, through it, all the members of the Ontario Legislature and the people of Ontario, to understand more fully the rate process and the impact of alternative approaches in the broad socio-economic context.

Appendix A

TERMS OF REFERENCE

Ordered, That a Select Committee of this House be appointed to review Ontario Hydro's proposals to increase bulk power rates for 1976, together with the report of the O.E.B. to the Minister of Energy thereon under section 37a of The Ontario Energy Board Act, dated October 10, 1975, and such other information as the Committee may consider relevant for its purpose, in light of the anti-inflation program of the Government of Canada; and the Ontario commitment to that program; and to prepare and submit a report before the end of December 1975, advising the Legislature whether, in the opinion of the Committee, such rate increase proposals are in keeping with or supportive of the anti-inflation program of the Government of Canada and the Ontario commitment to that program; and consistent with Ontario Hydro's obligation to provide power at cost; and if not, to report to the Legislature, with its recommendations.

In carrying out its terms of reference the Committee shall have regard to the following factors:

- Current economic conditions;

- Recovery of additional operating costs;

- Dependence upon adequate electricity supply for Ontario's future economic well-being;

- Maintenance of Hydro's financial integrity;

- Any provisions of the said program respecting increasing energy prices,

and that the Select Committee have authority to sit during the interval between sessions and have full power and authority to employ counsel and such other personnel as may be deemed advisable and to call for persons, papers and things, and to examine witnesses under oath and the Assembly doth command and compel attendance before the said Select Committee of such persons and the production of such papers and things as the Committee may deem necessary for any of its proceedings and deliberations, for which the Honourable Speaker may issue his warrant or warrants;

and the said committee to be composed of the following twelve Members: MacDonald, Chairman; Bullbrook, Deans, Drea, Gigantes, Grossman, Haggerty, Maeck, Peterson, Renwick, Williams and Wiseman.

And the said Committee may request such coverage of its proceedings by Hansard and the printing of such papers as the Committee deems appropriate.

WITNESSES APPEARING BEFORE THE COMMITTEE

GOVERNMENT OF ONTARIO

Hon. W.D. McKeough	Treasurer of Ontario and Minister of Economics and Intergovernmental Affairs
Hon. Dennis R. Timbrell	Minister of Energy
R.M. Dillon	Deputy Minister of Energy
Dr. H.F. Button	Staff Ministry of Energy
Dr. B.A. Finlay	Staff Ministry of Energy
Dr. A.E. Johnson	Staff Ministry of Energy

ONTARIO ENERGY BOARD

Bernard Jackson	Chairman
G.W. Clayton, P.Eng.	Member
W.W. Stevenson, Ph.D.,	Member
Miss S.J. Wychowanec, Q.C.	Member

ROYAL COMMISSION ON ELECTRIC POWER PLANNING

Dr. A. Porter	Chairman

ASSOCIATION OF MAJOR POWER CONSUMERS OF ONTARIO

W.K. Voss

J.K. Shurrie

K.E. Winrow

K.H. Kidd

ASSOCIATION OF MUNICIPALITIES OF ONTARIO

Mrs. G. Rolling

MacD. Dunbar

G. Kaiser

R. H. Pope, C.A.

ONTARIO MUNICIPAL ELECTRICAL ASSOCIATION

A.J. Bowker

OTHER WITNESSES

B. Farrill	President, McLeod, Young, Weir and Company Limited
D.C.H. Stanley	Vice President, Wood, Gundy Ltd.
R.B. Schmult	General Partner, Salomon Brothers New York
J. MacKay	Vice President, Salomon Brothers New York
S. Longshore	Assistant Vice President Canada Permanent Trust
D. Cass-Beggs	Chairman, B.C. Hydro

ONTARIO HYDRO

R.B. Taylor	Chairman
D.J. Gordon	President
M. Nastich	Vice President, Resources
H.J. Sissons	Vice President, Distribution
H.A. Smith	Vice President, Engineering and Operations
P.G. Campbell	
W. Cunningham	
C.G. Fullerton	
D.B. MacCarthy	
J. Matthew	
H.D. Smith	
W. Winter	
H.K. Wright	

ALLOWABLE RATE INCREASE - ALTERNATIVE I

- Bulk power revenue (1974)	$806,000,000	
- Bulk power cost excluding equity (1974)	$687,000,000	
- Bulk power net income (1974)	$119,000,000	
- Energy sold (1974)	78,288,000	MWH
- Actual income per MWH (1974)	$1.52	
- 1976 Forecast energy consumption	88,879,000	MWH
- 1976 Allowable net income 88,879,000 x $1.52	$135,000,000	
- 1976 Forecast bulk power costs excluding equity	$1,155,000,000	
- Allowable revenue (forecast)	$1,290,000,000	

$$\text{Rate Increase } \frac{\$1,290}{\$1,024} = 26\%$$

Note: 1976 revenue at 1975 rates (forecast) = $1,024,000,000

ALLOWABLE RATE INCREASE - ALTERNATIVE II

Average net profit margin

$= \dfrac{\text{net income (1970-74)}}{\text{total revenues (1970-74)}}$ = 10.52% Note 1

95% of net profit margin

= .95 x 10.52 = 9.984% or 10%

As sales minus cost = net profit margin

$\therefore$ Sales $= \dfrac{\text{cost}}{(100\%-10\%)} = \dfrac{\text{cost}}{.9}$

	$M
- Forecast bulk power costs (1976)	$1,304
- Less forecast equity charges (1976)	149
	$1,155

Allowable revenue $= \dfrac{\$1155}{.9}$ = $1,283

Allowable rate increase $\dfrac{\$1283}{\$1024}$ = 25.3% Note 2

Note 1: ($ million)

1970	Revenue $554	Net Income $70	% margin 12.6
1971	Revenue $630	Net Income $58	% margin 9.2
1972	Revenue $702	Net Income $54	% margin 7.7
1973	Revenue $855	Net Income $100	% margin 11.7
1974	Revenue $998	Net Income $126	% margin 12.6

Note 2: 1976 revenue at 1975 rates (forecast) = $1,024,000

ONTARIO HYDRO

Comparison of Source of Funds 1970-74 with Forecast 1975-79

($000,000)

	1970-1974						1975-1979					
	1970	1971	1972	1973	1974	Total	1975	1976	1977	1978	1979	Total
Internally Generated Funds												
Net Income	70	58	54	100	126	409	12	141	161	333	500	1,147
Depreciation	75	91	105	121	143	534	153	187	233	271	324	1,168
Amortization of Frequency Standardization	16	18	21	28		83						
Other items - net	3	-	-	3	2	8	9	8	10	12	12	54
Total	164	167	180	252	271	1,034	174	336	404	616	836	2,366
% of Total Funds	30.9	31.9	32.5	27.0	31.9	30.5	11.8	16.4	17.4	24.3	29.4	21.1
Externally Generated Funds												
Net proceeds from bond issue	364	360	440	403	506	2,073	1,217	1,465	1,778	1,733	1,804	7,997
Debt incurred on purchase	-	-	-	253	-	253	-	-	-	-	-	-
Increase /(Decrease) in notes payable	2	(4)	(67)	26	71	30	80	250	140	190	200	860
Total	366	356	373	683	577	2,356	1,297	1,715	1,918	1,923	2,004	8,857
% of Total Funds	69.1	68.1	67.5	73.0	68.1	69.5	88.2	83.6	82.6	75.7	70.6	78.9

Source· Ontario Hydro, December 1, 1975